

## CHAPTER 6:

### NET INCOME—NET RETURN—ADJUSTED CASH FLOW RULE CHANGES

#### IMPACT ON AMOUNT OF FUNDS FOR THE CHARITABLE/NONPROFIT PURPOSE

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**Overview.** For a number of years, the Commission has, at the request of licensees, reviewed and adjusted the rules related to the financial results of the licensees' C/NP gambling operations. The changes have often been made in response to licensees' problems in complying with the existing rules. The Commission has moved from regulating prize payouts (which had limits from 1983 through 2001) and net income/net return, to a more bottom-line-oriented approach reflected in the change to adjusted cash flow in 2001. Two summaries of all of the rule changes in this area were prepared as part of this project:

- Narrative table of rules changes by year—see Appendix D
- Spreadsheet of the actual formula changes in each rules revision—see Appendix D

The two summaries found in the Appendices trace both the regulatory history of the changes, as well as the financial details. The rules were changed in 1983, 1985, 1988, 1989, 1990, 1993, 1996, 1999, and 2001.

This analysis answers the following question: whether this series of rule changes has been successful in ensuring funds are directed toward the stated purposes of the C/NP organizations.

If the goal of the rule changes was to enable most licensees to comply and thus continue their C/NP gambling activities, then the effort was successful. And for those licensees who were unable to comply, the rules have been successful either in persuading the organizations to relinquish their licenses voluntarily or in allowing the Commission to revoke licenses for non-compliance.

If the goal of the rule changes was to sustain or increase the amount of money available for the C/NP purpose, then they did not succeed, and also “lowered the bar” considerably, especially for the Extra-Large Pool licensees. The rules changes reduced the required amount of net income/cash by 58% for the Extra-Large licensees between 1990 and 2001.

To provide some context, the Extra-Large Pool licensees accounted for:

- over 70% of the Net Income in Bingo in CY2003
- nearly 40% of Net Income in PB/PT in CY2003
- under 26% of the Net Income in Raffles in CY2003.

Thus, this reduction of requirements, while it improved compliance, certainly did not stop or slow the decline in Net Income and may have accelerated the decline in actual Net Income for the stated purposes. See Net Income by C/NP Activity chart, Chapter 2, page 14.

This is of even greater concern when the actual requirement for returning funds to the charitable purpose is considered. The licensee is required to return 60% of any given year's net income to its stated purpose, and of that 60%, 35% can go for administration and supporting services. In effect, the required amount that must be returned to direct services for clients, scholarships, etc. is 65% of 60%, or 39% of net income. When the decline in overall net income is taken into account, the amounts required to flow to the stated purpose's direct services are not large.

It appears from the regulatory history that the Commission spent considerable time from the mid-1980s to the late 1990s attempting to assist licensees who were finding C/NP gambling activities less and less profitable. At one point (1985-86 Annual Report), the Commission even stated that, "this Division is also heavily involved with charitable/nonprofit organizations, both as a regulator and **a facilitator of profitable operations.**" (emphasis added.)

It is also clear from the regulatory history that the Commission's understanding of its role in assisting, versus regulating or controlling, C/NP licensees, has shifted over time. This project did not find any specific basis in the legislative declarations or legislative history for the Commission's "assistance" role in terms of profitability. The Commission is urged—see Chapter 4, page 34 for more detail—to discuss and develop a clear and consistent philosophy for its overall approach to the C/NP sector, grounded in the legislative declarations and history.

**Analysis—Meeting the Requirement.** To test the impact of the nine rule changes, Commission staff members first created four Pools of Bingo licensees, by size:

Pool One (Small):	Up to \$25,000 in gross receipts
Pool Two (Medium):	\$25,001 - \$500,000
Pool Three (Large)	\$500,001 - \$3.5 million
Pool Four (Extra-Large):	\$3.5 million - \$10 million

Staff members then constructed a "typical licensee" for each Pool, based on the characteristics of all of the licensees in the Pool. The four "typical licensees" were each assigned appropriate figures for Bingo and PB/PT receipts gross receipts, net receipts, and expenses. The Net Income or Net Return or Adjusted Cash Flow (depending on what the rule required) was then computed. For comparability purposes, the same figures for each Pool were used throughout the analysis, so that the impact of each rule change was applied to the same base figures.

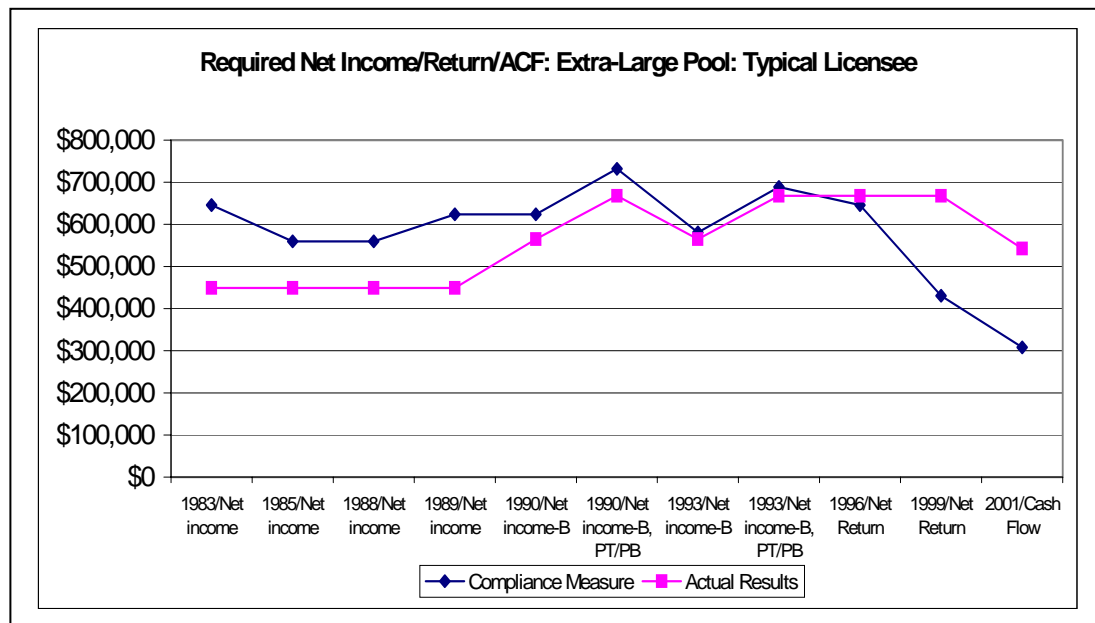
The results are startling.

For the Extra-Large Pool, the required levels of net income/net return/adjusted cash flow move steadily downward. The example licensee is out of compliance in 1983, 1985, 1988, 1989, 1990, and 1993. In 1996, the licensee is barely in compliance.

Only in 1989 and then when PB/PT income was added to the mix in 1990 did the required amounts rise. By 2001, the required cash flow of \$307,745 was 58% lower than the \$731,737 of net income required in 1990.

If any of these figures were adjusted to current dollars, the drop would be much more pronounced.

The chart on the next page shows the “typical” Extra-Large Pool licensee and how the requirements changed for that licensee through the nine rule changes. Note that while actual net income (gross receipts less prizes and expenses) is higher than the required amount, the required amount decreases significantly from 1999 to 2003, and the actual amount decreases somewhat.



For the Large Pool, the typical licensee was out of compliance with the 1983, 1985, and 1988 Net Income rules. From 1983 until 1988 the required net income amount for the Large Pool decreased. The required amount then fluctuated as high as \$161,000 (1990, with PB/PT included) and as low as \$48,000 in 1999. In 2003 the required cash flow was \$97,917, the second lowest level of any of the nine rules requirements.

For the Medium Pool, there were no requirements until 1989. From 1989 until 1993 these requirements were modest. In 1996, the requirements were lifted and not restored until the adjusted cash flow rule in 2001. The dollar amount required was never higher than \$2,300.

For the Small Pool, there were no requirements until 2001, when licensees were required to have \$1.00 of positive cash flow.

Because the example licensees in all Pools were in compliance by 1996, the actual amounts of net income exceed the requirement, sometimes by a great deal. However, the required amounts have dropped. A chart showing these figures for all four Pool sizes is found immediately following this narrative.

It should be noted here that some licensees who were having difficulty complying with the requirements at various times eventually chose to relinquish their licenses

voluntarily, or had their licenses revoked for failure to comply. Thus, the “typical” Extra-Large licensee, with its series of “non compliance” results, might well have given up or lost its license in real life. The examples are shown to provide a sense of how the dollar requirements evolved over time and are not intended to show the Commission’s enforcement actions for those situations.

**Analysis: Amounts to the Stated Purpose.** Meeting the requirement does not guarantee that all of the earnings are actually applied to the stated purpose. The Commission’s rules require the licensee to apply at least 60% of their net income/ net return/adjusted cash flow dollars to the stated purpose. This means that licensees are allowed to use up to 40% of the net income/net return/adjusted cash flow dollars for other purposes.

In addition, up to 35% of the 60% applied to the stated purpose can be used for administrative and supporting services. While those functions are important, they support the stated purpose, but are not the stated purpose.

The figures were analyzed to determine how much of the net income actually supported direct services.

Using the Extra Large Pool example, the numbers fall out as follows:

Year	Required Net or CF	60% for stated purpose	%of GR	39% for direct services	%of GR
(Col. 1)	(Col. 2)	(Col. 3)	(Col. 4)	(Col. 5)	(Col. 6)
1993-B+PB/PT	\$688,650	<b>\$413,190</b>	9.6%	<b>\$268,574</b>	6.5%
1996-NR	\$645,650	<b>\$387,390</b>	9.0%	<b>\$251,804</b>	5.8%
1999-NR	\$430,433	<b>\$258,260</b>	6.0%	<b>\$167,869</b>	3.9%
2001-ACF	\$307,745	<b>\$184,647</b>	4.3%	<b>\$120,021</b>	2.8%

This table shows in Column 3 (60%), that if a licensee in the Extra-Large Pool just met the minimum for net income/net return/adjusted cash flow from 1993 to 2001, the amount of money that that licensee would have been required to apply to the stated purpose would have decreased from \$413,190 to \$184,647. This is a decrease of nearly \$230,000, or 55%.

The percentage of this licensee’s gross receipts that actually end up supporting the stated purpose drop from 9.6% to 4.3% (Column 4). To run a \$4.3 million dollar C/NP gambling operation just to generate \$184,647 for the stated purpose appears to be a great deal of effort and expense for the yield.

Similarly, if the goal is to return funds to the direct services represented by the stated purpose—sports programs for kids, services for senior citizens, etc.—then a licensee could have returned as little as 39% of its net income to these direct services, as reflected in Column five. This would have decreased the amount of cash flowing to direct services from \$268,574 to \$120,021 between 1993 and 2001. To run a \$4.3

million dollar C/NP gambling operation just to generate \$120,021 for direct services also appears to be a great deal of effort and expense for the yield.

To a lesser degree this same dynamic applies to the Large Pool. The Medium Pool experienced an increase in the amount required for net income/net return/adjusted cash flow. The Small Pool had no limits through eight of the rules changes and only a \$1.00 cash flow requirement in the ninth.

In conclusion, the changes in the net income/net return/adjusted cash flow rules were made primarily at the request of, and to benefit, the largest licensees. The effect of the rules changes was to allow the largest licensees to come into compliance. However, the effect was also to reduce significantly the required cash flowing to the stated purpose.

The conditions that have caused the compliance problems for the largest licensees in the first place may not be factors that the Commission can influence through its rule-making process. Competition from Indian and commercial gambling, competition from other forms of entertainment, a finite market for C/NP gambling and increased expenses of operation all affect the profitability of C/NP gambling, especially Bingo. The Commission may wish to identify those factors that **can** be managed or influenced through rule-making. However if those factors cause a drop in the amount of cash required to be applied to the stated purpose, then the Commission might then assess whether that is the intent, either of RCW 9.46 or of the Commission itself.

**REQUIRED NET INCOME/NET RETURN/CASH FLOW BY POOL--IMPACT ON DOLLARS FOR CHARITABLE PURPOSE**

<b>Year/Rule</b>	<b>Small</b>	<b>Compl?</b>	<b>Medium</b>	<b>Compl?</b>	<b>Large</b>	<b>Compl?</b>	<b>Extra-Large</b>	<b>Compl?</b>
1983/Net income Actual NI	None 669	Yes	None 10,915	Yes	145,610 111,639	No	645,650 449,064	No
1985/Net income Actual NI	None 669	Yes	None 10,915	Yes	113,252 111,639	No	559,564 449,064	No
1988/Net income Actual NI	None 669	Yes	None 10,915	Yes	113,252 111,639	No	559,564 449,064	No
1989/Net income Actual NI	None 669	Yes	1,644 10,915	Yes	129,431 111,639	No	624,129 449,064	No
1990/Net income-B Actual NI-B	None 1,007	Yes	1,644 12,733	Yes	129,431 147,428	Yes	624,129 564,969	No
1990/Net income-B, PT/PB Actual NI-B, PB/PT	None 1,007	Yes	2,465 98,405	Yes	161,789 269,778	Yes	731,737 667,495	No
1993/Net income-B Actual NI-B	None 1,007	Yes	822 12,733	Yes	113,252 147,428	Yes	581,085 564,969	No
1993/Net income-B, PT/PB Actual NI-B, PB/PT	None 1,007	Yes	1,644 98,405	Yes	145,610 269,778	Yes	688,694 667,495	No
1996/Net Return Actual NR	None 1,007	Yes	None 98,405	Yes	129,431 269,778	Yes	645,650 667,495	Yes
1999/Net Return Actual NR	None 1,007	Yes	None 98,405	Yes	48,537 269,778	Yes	430,433 667,495	Yes
2001/Cash Flow Actual Cash Flow	1 1,007	Yes	2,269 97,711	Yes	97,917 202,729	Yes	307,745 542,199	Yes